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## Transatlantic Divergence

"Thus we are presented with a choice between more employment with lower real wages and less employment with higher real wages."

Joan Robinson  
Collected Economic Papers, 1973

Fears of faster growth and higher inflation have spread on Wall Street from the bond to the stock market, where they threaten to overpower the perennial optimism over the outlook for corporate profits. Still traumatized by the debacle of 1994, Wall Street's traders and speculators look with foreboding to the prospect of another round of Fed rate hikes.

Across the Atlantic, the outlook hardly could be more different. Unemployment, not excessive growth, is the specter haunting the European economies. Low German interest rates have breathed new life into the speculative game of European bond-yield convergence. Bond markets in Italy, Spain and the other soft-currency countries have experienced powerful rallies.

Adding fuel to those rallies: an emerging consensus that Europe's politicians will push ahead with European Monetary Union, despite the increasingly obvious inability of most EU countries to meet the necessary fiscal criteria. That this willingness to bend the rules threatens to render all of continental Europe a soft-currency zone appears to faze the speculative community not a bit. Surely, there is conclusive proof of Europe's minimal inflationary expectations.

In this issue, we explore the growing divergence between the European and U.S. real economies, and the implications for financial markets, above all, for the dollar. Increasingly, we find ourselves agreeing with those who warn of a coming acceleration in U.S. consumer- and producer-price inflation. But while markets focus myopically on commodity supply shocks, we see a more elementary danger in the recent surge in U.S. wage growth. This, far more than raw materials prices, is the stuff of which inflationary episodes are made.

At the root of our concern is the persistently sluggish pace of U.S. productivity growth. Now that revised, more accurate statistics have demolished bullish dreams of a miraculous secular improvement in U.S. productivity, it should be obvious that even a modest acceleration in wages has ominous inflationary implications.

The real question for investors: will the Fed move promptly to combat a wage-driven acceleration in U.S. inflation? At the moment, the Fed shows little inclination to do so, particularly as the United States moves closer to its presidential election. Yet delay only increases aura of uncertainty hanging over the markets, raising the odds of a violent reaction when and if the Fed finally moves.

The possible consequences for the dollar are highly negative, to say the least. The risks are compounded by the fact that foreign private investors in general were latecomers to the U.S. bull run of 1995. Initially heavily underweighted in U.S. stocks and bonds, many are drastically overweighted. Any signs of a major market correction could trigger a general stampede of foreign investors, sending the dollar tumbling.

This appears less of a threat to the dollar's strength against the yen, given the Bank of Japan's determination to defend the greenback. But it could lead to a sharp downward move against the DM. Traditionally, periods of dollar weakness have been associated with equally severe declines in the European soft currencies. Extreme caution is warranted.

## EUROPE'S MALAISE

While German, French and EU officials incessantly are voicing their assurances that the European single-currency program is on track, it is becoming clear that most EU states will fail to hit the key public deficit criterion of 3% of GDP for joining EMU. Last but not least, even France and Germany have a high chance of missing the target.

Currently, only three small countries – Ireland, Luxembourg and Denmark – are complying fully with this entry condition. Ironically, the worst performer last year was Germany. If other countries generally failed to realize the deficit cuts they had intended, Germany distinguished itself in this regard. The federal budget deficit rose from 2.6% of GDP in 1994 to 3.5% in 1995 and is presently heading for 4% in 1996.

EMU implementation is scheduled for January 1, 1999, and according to the Maastricht time table, decisions about qualification for membership are to be taken "as early as possible in 1998" on the basis of complete data for 1997. This leaves just one more year to meet the Maastricht test.

When the European Commission recently unveiled its new economic forecast, its outlook was suffused with optimism. While slashing its 1996 growth projection for the 15 EU member states to 1.5%, from the 2.6% it forecast just six months ago, the commission expressed a conviction that the European economies would rebound sharply in the second half of the year, leading to a 1997 growth rate of 2.4%.

While the predicted acceleration in economic growth hardly is spectacular, it nevertheless has miraculous results on the commission's fiscal bookkeeping. The budget situation in Europe improves dramatically. Austria and Sweden are projected to miss the 3% deficit target by only a narrow margin, while France and Germany just as narrowly squeak through.

Looking at the table above, it strikes the eye that some countries that previously had been addicted to extremely high budget deficits have done a magnificent job of fiscal retrenchment in the past few years, in particular Sweden, Finland, Portugal, Denmark and Italy. By comparison, the corresponding efforts and achievements in France and Germany make for very poor reading.

Governments in both countries have had the advantage of starting with much lower deficits, but both seem incapable of forceful action, let alone of devising plausible, integrated long-term strategies for freeing their economies from the shackles of existing welfare-state excesses and associated labor market and wage rigidities. What the two government have delivered so far is patchwork at best.

According to press reports, the Paris-based Organization for Economic Cooperation and Development recently raised its concern at a conference of finance ministers from the OECD member states that the European Union risks undermining its credibility and upsetting the financial markets once the markets begin to realize that most EU member

Europe: Fiscal Deficits as % of GDP				
	* Projected			
	1994	1995	1996*	1997*
Belgium	5.3%	4.5%	3.2%	3.7%
Denmark	3.8%	2.0%	0.9%	0.6%
Germany	2.6%	3.5%	3.9%	2.9%
Finland	5.8%	5.4%	3.3%	1.6%
France	6.0%	5.0%	4.2%	3.0%
Greece	11.4%	9.3%	8.1%	6.9%
Great Britain	6.8%	5.1%	4.4%	3.7%
Ireland	2.1%	2.7%	2.0%	1.6%
Italy	9.0%	7.4%	6.1%	4.9%
Luxembourg	+2.2%	+0.4%	+0.7%	+0.3%
Netherlands	3.2%	3.1%	3.5%	2.9%
Austria	4.4%	5.5%	4.6%	3.1%
Portugal	5.8%	5.4%	4.4%	3.7%
Sweden	10.4%	7.0%	5.2%	3.1%
Spain	6.6%	5.9%	4.8%	3.8%

Source: Bundesbank, European Commission

## Global Capital Market Trends

### Equities

Selected Markets, % Change

Country (May 31)	Month	YTD	Y-Y	Vs. 12- Mo. Hi	Vs. 12- Mo. Lo
Australia	-2.2%	2.9%	12.2%	-2.6%	15.6%
Canada	1.9%	11.3%	17.9%	0.0%	21.6%
France	-1.7%	12.7%	8.3%	-1.7%	22.6%
Germany	1.5%	12.8%	21.5%	-1.1%	22.0%
Hong Kong	2.7%	11.8%	19.7%	-2.8%	26.6%
Japan	-0.4%	10.5%	42.2%	-1.5%	51.6%
Mexico	0.6%	15.4%	64.8%	-4.4%	64.8%
Spain	0.7%	13.2%	27.4%	-1.3%	28.9%
U.K.	-1.8%	1.6%	12.9%	-2.8%	14.2%
U.S.	2.3%	8.6%	25.4%	-1.4%	26.7%

### Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (May 31)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12- Mo. Hi	Vs. 12- Mo. Lo
Australia	8.96	23	69	3	-46	99
Canada	7.70	-9	62	-19	-77	76
France	6.51	11	-12	-93	-112	24
Germany	6.50	16	47	-15	-44	70
Japan	3.24	-22	17	37	-30	64
Spain	9.25	11	-45	-233	-261	22
U.K.	8.14	11	72	23	-33	90
U.S.	6.85	18	128	157	-5	133

### Exchange Rates

Versus U.S. Dollar, % Change

Country (May 31)	Current Rate	Month	YTD	Y-Y	Vs. 12- Mo. Hi	Vs. 12- Mo. Lo
Australia (\$)	1.25	1.4%	7.0%	10.1%	-3.3%	11.3%
Canada (\$)	1.37	-0.4%	-0.1%	0.2%	-2.8%	1.3%
France (f)	5.16	0.3%	-5.0%	-3.7%	-8.4%	1.4%
Germany (DM)	1.52	0.6%	-5.9%	-7.6%	-10.8%	1.6%
Japan (¥)	108.1	-2.8%	-4.4%	-27.7%	-28.6%	0.7%
Spain (P)	128.2	-0.7%	-5.4%	-4.1%	-8.5%	1.0%
U.K. (£)	1.55	3.0%	0.1%	-2.2%	-3.8%	3.9%

differential between French and German 10-year bond yields has shrunk by 120 basis points, to zero, while the corresponding spreads of Italian, Spanish, Swedish and Portuguese yields have even plunged by 200-225 basis points. The notable exception from this convergence trend have been British gilts – not surprising, given the British government's well-known negative position on EMU.

Though the sway of EMU is evident, there certainly also are other influences at work, such as easier money and lower inflation across much of Europe. Yet there have been two similar periods of drastic yield convergence in Europe within the last five years – from 1991 to early 1992, and from early 1993 to early 1994. On closer look, it appears the bonds of Europe's high-yielding currencies have a habit of rising and falling much faster than German bond yields.

states will be unable to meet EMU's 3% deficit target. It is reported the secretariat presented projections showing that "most countries, including France and Germany, are sure to miss this target."

The response of the conferees remains confidential, but informed observers of the financial markets interviewed by the *Wall Street Journal* discarded the OECD's concerns as totally misguided. Their reassuring argument is that most market participants have no illusions in the first place about the ability of most EU states to meet the Maastricht criteria, yet take it for granted that Europe's politicians in any event will implement EMU by fudging their way into it on loose terms, regardless of any missed criteria.

However, far from shocking and upsetting the markets, the emerging prospect of wholesale EMU cheating instead apparently has inspired international investors and speculators to stampede into the high-yielding bonds of Europe's soft-currency countries, who are eager to join the EMU club.

The main beneficiaries of this speculative frenzy have been Italian, Spanish, Portuguese and Swedish bonds. Defying the steep global rise in bond yields that started in early February, their yields, after a brief hiccup, have continued to decline.

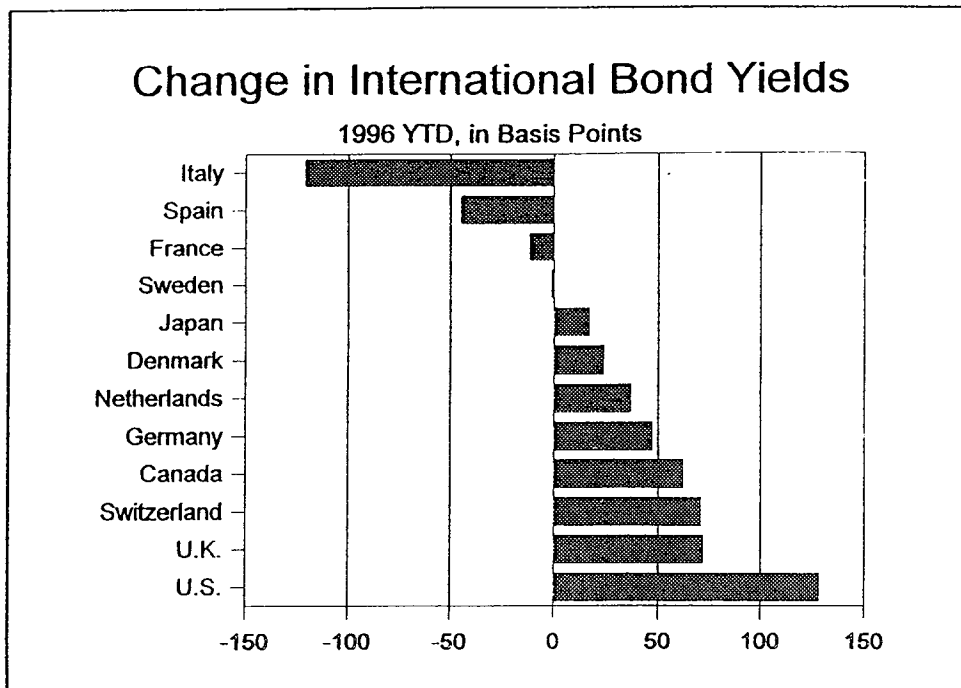
The result has been an extremely unusual divergence of global yield moves. The worst performer so far in 1996 has been the U.S. bond market, with a yield increase for 10-year Treasuries of 125 basis points; the best performers have been Italian bonds, with a yield decrease of 121 basis points for equivalent maturities.

### ANOTHER CONVERGENCE PLAY

Another striking recent feature of European bond market developments has been a drastic narrowing of soft-currency yield spreads versus considerably lower German yields, which started last autumn. The

Actually, today's spreads versus German yields, although sharply below their last highs in early 1994, are still above their levels of early 1994. This, and some other observations, make us rather wary to ascribe this general plunge of European yield differentials exclusively to EMU anticipation. Still, that yields have fallen even in the face of an opposing global uptrend truly is an unprecedented occurrence.

It is worth noting that in the past such periods of European yield convergence always have tended to coincide with periods of dollar strength, suggesting that a strong greenback tends to bolster the weaker European currencies against the DM and vice versa.



So far, the process of European yield convergence has remained in full swing, but it remains vulnerable to some diversion that may reflect country-specific factors. The main risk would be higher German rates, possibly triggered either by the pull of further rises in U.S. rates, or by Bundesbank rate hikes in response to a strengthening German economy. The latter is impossible, while the former appears in our eyes rather improbable.

Concerns about inflation nowhere are an issue in the European financial markets. Contradicting the widespread fears in the U.S. markets, most European analysts view the recent surge in the prices of oil and some other commodities largely as a result of supply shocks, rather than a precursor of a general acceleration in inflation.

This difference in attitude has an obvious reason: While the U.S. markets agonize over the threat of an overheating expansion, Europeans agonize over economic weakness, if not outright recession, combined with record unemployment.

Nevertheless, considering that this "convergence play" in Europe's bond markets certainly contains a large speculative element, a sudden sell-off always is possible. We wonder, for example, how much leveraged buying or "carry trade" playing with borrowed cheap DM is responsible for the surge in soft-currency bond prices.

### **THE COSTS OF EURO-FUDGING**

There is a growing acceptance in the markets that EMU will happen as scheduled on January 1, 1999. This takes it for granted that the politicians will bend the entry criteria, despite their vehement, contrary assurances. We don't doubt that cheating is on their minds, but for the time being they appear to hope the expected economic recovery in Europe will bail them out with sharply rising tax revenues, saving them from the embarrassment of large-scale fudging.

We think the only question is what degree of cheating will be required. Once the softening process begins, it will be difficult to hold a line. Decisions about entry will become completely arbitrary, which is bound to cause bad blood. How can the French and Germans refuse participation to others, if they themselves fail to meet the key fiscal test?

Most importantly, in the eyes of the public and the perceptions of the markets, any substantial weakening of the convergence criteria would discredit the monetary union even before it is implemented. It definitely would signal to the

world that this is a soft-currency area in the making. This would have devastating effects, particularly on the bond markets of the hard-currency countries.

In any case, it is our opinion that long before EMU becomes a reality, Europe's politicians will have discredited themselves by their failure to relieve the continent's pressing unemployment problem.

### **EUROPE'S DISGRACE: UNEMPLOYMENT**

Protracted economic weakness may be seen as a blessing for Europe's bond markets, but the level and recent sharp rise of unemployment has reached a point where the public finally has taken alarm, forcing political leaders to act, albeit in a highly inefficient way.

In reality, European unemployment has been in a relentless uptrend for almost 30 years, despite very low population growth. In the late 1960s, Europe's unemployment rate averaged 2.2% of the work force, compared to 4.7% in the United States. During the 1970s, the European rate rose to 4%, and the U.S. rate to 6.4%. But in the 1980s, the relationship reversed. A surge in the EU unemployment rate to an average 8.9% compared with a modest increase in the U.S. rate to 7.1%. Now, the EU rate is 11%, virtually twice the U.S. rate of 5.5%. And to be sure, Europe also has a lot of concealed unemployment. This dismal trend is all the more remarkable, given Europe's minimal population and work force growth.

At long last, spurred by this alarming trend, Europe's politicians have been aroused to hectic activity in the form of various employment conferences and programs. But everything that is said and done reveals a hopeless indecision and a complete unwillingness to undertake the necessary comprehensive reform measures. Still, one thing at least is working: at last, there is unprecedented wage moderation. For the first time ever, European real wages are stagnating or even falling.

### **THE BIG U.S. FAILURE: PRODUCTIVITY GROWTH**

The shining example of strong job creation today is the United States, which has seen an overall increase in employment of 26 million jobs since 1980, a 27% increase. This compares to stagnating or lately even falling employment in Europe. However, these figures have to be interpreted in light of the fact that Europe had only 5% population growth over that period, compared to 15% growth in the United States.

Yet, despite its much stronger employment track record, U.S. economic growth – as measured by real GDP – only lately has outpaced European growth. In the 1960s, average annual GDP growth of 4.8% in Europe compared with 3.8% growth in the United States. In the 1970s, the comparison was 3% to 2.7%; in the 1980s, it was 2.4% to 2.7%, respectively.

The really decisive, big difference between the two continents is in productivity growth. During the 1960s, real GDP growth per employed person was 4.6% in Europe and 1.9% in the United States. In the next decade, the 1970s, labor productivity growth in Europe fell to 2.7%, but in the United States it plunged to an abysmally low 1%. During the 1980s, productivity growth in Europe declined further, to 1.9%, versus 0.9% in the United States. More recently, Europe's productivity gains have remained on the high side of 2% per annum, while in the United States they have kept to the low side of 1%.

Currently, the EU's long-run GDP growth potential is estimated to be approximately 2.25%, quite similar to the U.S. rate. The snag, however, is that this rate of economic growth involves virtually no job creation in Europe, owing to the continent's high productivity gains, while in the United States, with its low productivity performance, it implies strong employment growth.

Bearing these differences in mind, we don't share the general admiration in the financial markets for the allegedly superior U.S. employment performance. Its ugly corollary has been and continues to be inferior productivity performance.

## THE PRODUCTIVITY DILEMMA

Productivity growth is the key source of rising living standards. But in periods of low growth, it destroys jobs. Europe's great economic dilemma today lies in the fact that in order to reduce unemployment in the face of 2% productivity growth requires sustained 3% economic growth, while its noninflationary potential is only 2.25%.

In theory, there are two possible ways to cope with such a problem. One is to upgrade economic structures by boosting capacity-expanding, job-creating investment at the expense of consumption. The other is to downgrade economic structures, that is, to resign oneself to permanently lower economic growth but to stimulate the creation of low-skilled, low-productivity jobs by allowing low wages.

Of the two approaches, only the second one currently is feasible. Like America in the 1980s, Europe has to adjust its output and employment structure to match its sharply lowered rate of capital formation, which has been ravaged by public spending and borrowing excesses. The trouble is that Europe's welfare systems are too generous and its wage structures too rigid to facilitate such a transformation.

## THE DUTCH EXAMPLE FOR EUROPE

Still, it happens that one hard-currency country in Europe, the Netherlands, has over many years managed to apply the medicine of wage moderation – with sweeping success in terms of booming exports and rising job creation, defying the guilder's steady appreciation.

In its recently published annual report, the Dutch central bank boasts that the loss of international competitiveness through the rise of the guilder, which is strictly linked to the DM, has been more than offset by wage increases that consistently are lower than those of its major trading partners.

The results of this wage policy speak for themselves. The Netherlands has a steadily rising current-account surplus, which in 1995 hit 4.5% of GDP. Employment has risen 10% since 1990. And despite the strongest population growth in Europe, the Netherlands has the lowest unemployment rate.

Wage moderation has had profound structural effects on the domestic economy. As the factor price of labor has fallen compared to capital, the previous substitution of capital for labor has eased considerably. A coincident effect has been a progressive slowdown in productivity growth, leading instantly to more labor-intensive economic growth.

In the early 1980s, productivity gains accounted for no less than 70% of Dutch GDP growth, while additional employment contributed just 20-30%. These ratios since have been completely reversed. In the first half of the 1990s, the productivity component fell to 30% while the employment component rose to 70%. Dutch productivity growth has run an average 0.5% a year in the 1990s, down from 1.2% in the 1980s. That's one of the lowest rates in Europe.

To complete the picture, we have to add that strong job creation in the Netherlands, as in the United States, is concentrated heavily in part-time employment. The proportion of part-time workers increased from an already high level of 21.1% in 1983 to 35% in 1993.

## THE GERMAN SCAPEGOAT

We have gone into this rather detailed description of the economic situation in the Netherlands because it inspires comparison both with Germany and the United States. Above all, it confirms the key role of wage policy in creating or destroying employment. In this respect, wages are far more important than the exchange rate.

This is naturally true, because employment in every country is dominated by activities in non-traded goods and services not exposed to foreign competition, such as construction, wholesale and retail trade, transport, and public and

private services. Among the industrial countries, internationally traded goods and services account for no more than 25-35% of domestic employment.

We stress this fact with a very critical eye on German policymakers – unfortunately including leading members of the Bundesbank – who have developed a habitual tendency to blame the German economy's recent disappointing performance primarily on the strong DM. This is utter nonsense – all the more so in light of the fact that the thrust to the 1993-95 recovery came mainly from merchandise exports. All the non-traded sectors, unaffected by the exchange rate, lagged badly.

Not only was the German recovery a jobless recovery, it was the first ever to be marked by considerable job destruction. The reason is clear: soaring productivity growth far exceeded economic growth. During the three years 1993-95, employment fell by about 1 million, as soaring productivity growth outpaced economic growth by a considerable margin, indicating a big job shake-out. While job losses took place across the board, the manufacturing sector was the biggest loser.

As we pointed out, this unprecedented job destruction essentially stemmed from a combination of causes. Yet for the policymakers, the appreciation of the DM has become their favorite scapegoat, conveniently cloaking their own gross failures in the arenas of fiscal policy, wage policy and welfare policy.

Since 1991, Germany's merchandise trade surplus has jumped from DM 22 billion to DM 91 billion, an increase equal to more than 2% of GDP. Further improvements in the trade and current-account balances are to be expected, given the reappearance of a strong growth differential between the United States and Europe. True, Germany's share of world exports has fallen from 12.5% in 1989 to 11% presently, but that appears natural in the wake of unification, which absorbed and continues to absorb enormous domestic resources.

Will the German economy turn the corner? With respect to wage moderation, we are fairly certain of its imminent realization. At long last, business is revolting against the former obsession with "consensus" at any price. The unemployment numbers finally are too shocking to be ignored by the trade unions. Recent wage agreements in the private sector have called for annual gains of between 1.5% and 1.85%, minimally higher than the inflation rate and far below labor productivity growth.

At the same time, reasonable agreements are proliferating at the level of individual companies. As no law dictates participation in national wage agreements between employers and trade unions, more and more companies are fleeing their bargaining associations.

By contrast, we are distinctly less optimistic about the ability and willingness of Germany's politicians to do their necessary part to revitalize the economy by cutting welfare excesses and taxes and removing the legal rigidities built into the labor market.

### **THE BOND CONUNDRUM**

Another object of highly critical international attention is the German bond market. The yawning gap between a short-term rate of 3.3% and 10-year bond yields currently close to 6.5% has given rise to considerable speculation about its underlying causes. Being unable to think of any other explanation, conventional wisdom takes it as axiomatic that such a big yield gap must reflect expectations of a resurgence of inflation in Germany.

We are equally sure that it does not. Speaking of the German investor, we are absolutely certain that there is not a trace of inflationary expectations in his head. But his experience of more than 40 years tells him that bond yields below 6% are unsustainable. Typically, he stopped buying 10-year Bunds last autumn, when their yield hit 6.25%. Exactly the same thing happened in 1993, even as frenzied international speculation drove long-term Bund yields below 6%.

Even if the Bundesbank further lowers its repo rate, the German investor will not buy. For he doesn't speculate with borrowed money; he invests his precious savings.

It is true, international speculators also have neglected German bonds lately. But here again, this has an obvious reason other than inflationary expectations. Once again, the speculating crowd has concentrated on the high-yielding European currencies, postulating convergence with DM yields, which is always at the expense of the DM and the German bond market. Also, by the way, it tends to be associated with a strengthening dollar, though causes and effects are difficult to disentangle. Still, sooner rather than later, we think this speculative play will exhaust itself.

### **WHAT REALLY DRIVES THE U.S. JOBS MACHINE?**

For good reasons, the markets have become highly critical of economic developments in Germany and Europe. We agree. But we don't agree at all with the contrary, unqualified admiration for the U.S. "shareholder" economy and its overriding adherence to the principle that maximizing profits and share values is the one and only legitimate goal of corporations.

Two features of the U.S. economy, in particular, are attracting general attention and admiration. One is the pattern of booming job growth; the other is the endless stock-market boom, which has been underpinned by excellent profit performance. Together, these spectacular feats tend to foster the notion of outstanding U.S. economic health, which many attribute to the inherent superior efficiencies of a strictly profit-oriented shareholder economy.

From this perception we must demur. Strong job creation in the United States is primarily to the credit of the American people, and by no means to the credit of corporate management. At its root, in the last analysis, is the singular flexibility and mobility of American workers, who have adjusted their wage demands downward to declining productivity growth. Over the last 20 years, average U.S. real weekly earnings have slowly but steadily declined.

Creating jobs with high and rising wages depends on high savings and investment ratios, allowing heavy productivity-enhancing investment. But in the 1980s, both U.S. ratios fell sharply. Maintaining a high rate of job creation required a shift in the growth pattern towards labor-intensive production, implying lower productivity growth.

This necessary shift in the growth pattern promptly took place. The chief instrument towards this end was the downward trend in real wage rates, which paved the way for the creation of cheap, low-productivity jobs. That's what has been driving the U.S. jobs machine.

Of course, from the perspective of market flexibility and efficiency, such timely adjustment to lower capital formation is most impressive. But we repeat, this definitely is not to the credit of corporate managers and the shareholder economy. It clearly results from the fact that the United States is blessed with a highly flexible labor force and labor markets. In fact, looking at the low and falling unemployment rate, and the miserable trend in productivity growth, it well may be that U.S. labor has become too cheap.

Europe, too, must cope with sharply diminished capital formation, though for different reasons than in the United States. Welfare excesses, high taxes and exploding budget deficits have become a tremendous burden on the profits share of national income, discouraging investment. At the same time, rigid labor markets and labor laws have obstructed the necessary wage adjustments. Only now, in the presence of truly alarming unemployment, does that resistance seem to crack.

### **THE SHAREHOLDER ECONOMY VERSUS THE STAKEHOLDER ECONOMY**

What, then, are the true benefits of U.S.-style shareholder economics, in which share prices are the key measure of corporate performance? Frankly speaking, we have difficulty seeing any benefits at all, the obvious reason being that the primacy of share prices as a valuation measure tends to drive corporate management away from longer-term investment and towards short-term opportunities for raising profits.

To put it as plainly as possible: The decisive and distinguishing hallmark of the shareholder economy – prevalent above all in the United States and Britain – is a bias towards the short-term horizon, that is, towards corporate cost

cutting in conjunction with mergers and acquisitions, rather than towards new productive investment. It is a brutal world of open-ended downsizing and paper-asset shuffling. While Wall Street bulls hail the profit-enhancing effects of these activities, it should be patently clear that the resulting rise in corporate profits is a one-time windfall, not a recurring trend.

The truly devastating part of the story, however, is that despite the slash-and-burn restructuring strategies of U.S. corporations, the U.S. economy as a whole has completely failed to improve productivity growth, running far behind stakeholder Europe in this respect. Downsizing has helped profits, to be sure, but it has not improved overall efficiency and productivity.

Since 1990, the U.S. economy has had a cumulative gain in overall productivity of just 5%, compared to a corresponding gain in Germany of 13%, a figure, by the way, which makes obvious the reason for Germany's worsening unemployment problem.

### **MERGER MANIA DISPLACES NEW INVESTMENT**

Instead of expanding and developing their resources, too many U.S. corporations have retreated to cost cutting as their main source of higher profits. The U.S. shareholder economy's twin fault lines are too many mergers and acquisitions driven by the corporate desire for quick and easy profits, and too little new domestic investment. Last year alone, merger activity exceeded \$400 billion, of which nearly \$200 billion involved cash payments, heavily financed by corporate borrowing.

The second, related U.S. fault line lies in the grossly imbalanced output structure, the result of persistent overinvestment in consumer-related services and a long-standing neglect of domestic manufacturing investment in favor of foreign direct investment in low-wage countries. During most of the 1980s, net investment in U.S. domestic manufacturing was next to nothing.

All this has left the U.S. economy with a grossly inadequate capital stock in manufacturing, one that is incapable of producing sufficient merchandise exports to pay for rising imports, which have been inflated by exorbitant consumer borrowing and spending.

While stressing the inferior productivity performance of the U.S. economy in aggregate, we realize perfectly well that in Corporate America there are numerous exceptions to the dismal average. The most spectacular case, of course, is the booming high-tech sector. But its size – about 3% of aggregate output – is far too small to appreciably impact overall productivity.

Exceptionally strong equipment investment has been widely hailed as the great positive hallmark of the U.S. economy's recovery since 1991. This would seem to lend support to the common view of an ongoing U.S. productivity miracle. But in retrospect, it turns out that only investment in computers and peripheral equipment has been exceptionally strong. Excluding these components, plant and equipment spending has not exceeded its weak historical trend. Perhaps there is overinvestment in information and underinvestment in production facilities.

### **U.S. WAGE INFLATION**

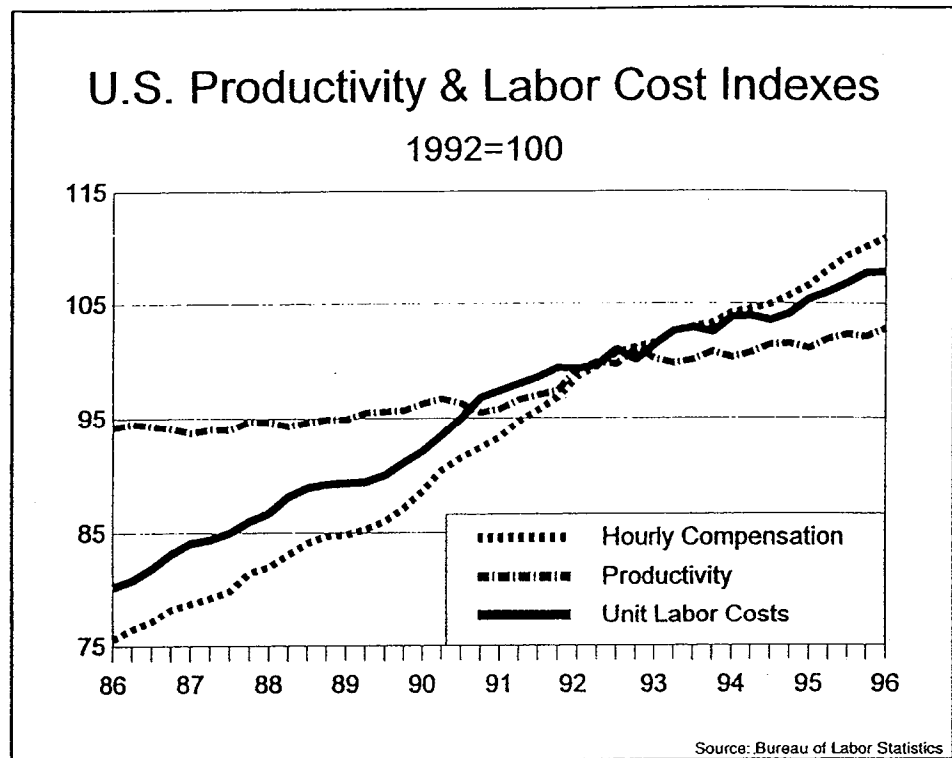
Comparing the economic situation and outlook in the United States and Europe, it is a striking fact that the present U.S. inflation scare has no corollary in Europe. This has some good, obvious reasons. In recent years there has been a substantial transatlantic divergence in capacity utilization, unemployment and wage and productivity trends. The U.S. economy is operating close to its capacity, with a pretty tight labor market. Most countries in Europe, by contrast, are struggling with considerable underutilized industrial capacities and high unemployment.

After another close look, we must confess some sympathy for those warning of higher U.S. inflation. In our view, though, the problem lies more in the growing gap between accelerating wage hikes and dismal productivity growth than in rising commodity prices.

A few figures highlight the dilemma. Since 1992, U.S. compensation per hour (wages plus benefits and employers' contributions for social insurance) has increased by 10%. As this virtually equalled the simultaneous rise in consumer inflation, the net effect was zero real wage growth.

The potential inflationary threat to the United States, of which the handwriting is on the wall, arises from the abysmal trend in U.S. productivity growth.

The overall wage rise of 10% during the three years 1993-95 was matched by an overall productivity gain of little more than 2%, implying a formidable 8% surge in unit labor costs.



What gives reason for serious concern is the fact that wage hikes perked up in the course of 1995. Assuming the current expansion continues into 1997, this trend easily could accelerate.

By comparison, during the same 1993-95 period of time Germany had roughly the same rise in wage rates of about 10%. This was attended, however, by a productivity gain of about 9%. Consumer prices advanced 8%, a good part of it from increasing indirect taxes. Recent wage hikes and inflation rates both are down sharply, to less than 2%. Given the sluggish economy and the considerable German output gap, there is every reason to expect these rates to last for the foreseeable future.

The current, crucial issue for the United States is wage inflation, driven by a tight labor market and extremely poor productivity performance. Together, these factors well may push the CPI towards 4%. That still appears low compared to the double-digit inflation rates of the 1970s and the early 1980s. But in today's global environment, it leaves the United States distinctly in the high-inflation camp of countries. The question investors in the U.S. markets must ask themselves: Will the Fed fight creeping wage inflation?

### **ONCE MORE: THE LIQUIDITY MIRAGE**

The inflation scare roiling the U.S. bond market plainly is of a totally different kind. It centers on the recent run-up in commodity prices and the perception that this will be swept up in an imminent, synchronized world economic recovery, fueled by the excess liquidity that the central banks allegedly have created.

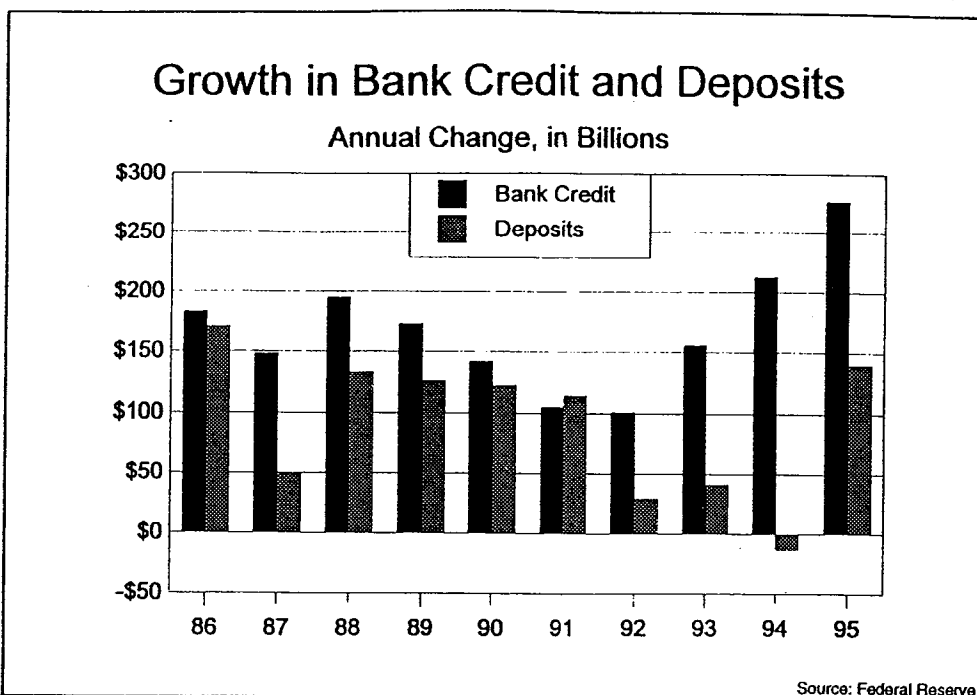
Actually, we do agree with the view that monetary policy is extremely loose globally. We go even further and say that it's out of control. Credit is abundantly available. What is missing, however, is abundant credit demand for spending on goods and services. Governments are curtailing their budget deficits and businesses are keeping a lid on investments and inventories. The bulk of corporate borrowing is used to finance the merger mania. But this drives up share prices, not goods prices.

As to the current allegations of runaway money growth, we stick to our view that the "vast liquidity creation," of which many American commentators speak, is a hallucination.

As we explained in our last letter, the recent surge in U.S. broad money has its only reason in the change in bank funding towards deposits. Bank credit growth itself has drastically slowed.

So far this year, total bank credit has expanded at an annual rate of \$132 billion, compared to \$270 billion in 1995. Total non-financial borrowing and lending is up only slightly from last year.

But in looking for signs of inflation, it should be emphasized that these U.S. credit totals have been and continue to be distorted by speculative finance. Instead of fueling demand for goods and services, a large part of this debt is fueling financial speculation and takeovers.



### REFLATION FALTERS IN JAPAN

In the same vein, we continue to take issue with the story that the Bank of Japan is now pressing the reflationary button with a vengeance and that these huge liquidity injections sooner or later will flood the world economy and the financial markets, while continuing to weaken the yen. It seems that some people too readily jump on isolated pieces of data that seem to confirm their wishes or preconceived views.

As we prefer to be late rather than incorrect, we always withhold judgement on Japanese monetary matters until we have complete data, both for the Bank of Japan and for the Japanese commercial banks. As it turns out, the Bank of Japan did undertake two unusually big transactions in March that seem to have given rise to the view of ongoing massive reflation.

The one operation was a huge addition to the BoJ's government bond portfolio of around \$40 billion. But all of the money created by these bond purchases remained as deposits with the central bank. This suggests that the operation was intended to support the bond market. But by the same token, the liquidity effect was in this way neutralized. At the same time, the BoJ placed an similar sized amount in "deposits with agencies," which suggests an operation to aid troubled banks.

In any case, we have to repeat our earlier admonitions that the effectiveness of what a central bank does depends in the last analysis on the response of the banking system in expanding its loans or investments. The central banks create bank reserves, but the commercial banks are the chief creators of money through their lending to governments, businesses and consumers. Therefore, the key point to watch is how long it takes for monetary growth to respond to central-bank easing.

According to the latest data, the Japanese commercial banks and their potential borrowers remain completely unresponsive to the existing super-low interest rates. This is reflected in near-stagnant bank lending and equally persistent near stagnation of broad money growth. Any global reflation stories that refer to Japan as a major source of liquidity in this respect are misplaced. In any case, Japan's declining trade surplus is rapidly drying up the ultimate source of Japan's capital outflows.

## CONCLUSIONS

In the first place, we dispute the new perception that the industrial world is being swept by the combined reflationary zeal of its central banks, heralding a synchronized world economic boom that will fuel general inflation. Money is clearly loose, as evidenced by the prolonged boom in the financial markets. But its leverage on the real economies has become wanting.

Still, the United States definitely has an inflation problem. Its main ingredients are near-full employment, low savings, abysmal productivity growth, accelerating wages (wage inflation) and the consumer-borrowing binge. But America is virtually alone with these inflationary pressures.

Various statements from Fed officials suggest that some policymakers share the inflation worries. If economic indicators continue on the strong side, the Fed could hardly avoid raising its rates. Its credibility is at stake.

We are not yet convinced of a sustained U.S. economic rebound. But what counts for the markets is the prevailing perception, which is determined by the short-term outlook. Either way, wage inflation spells trouble for prices and profits – and for the financial markets. The emerging profits squeeze is a reality, though completely ignored. Since early 1995, profits have risen about 5%, while stock prices have soared roughly 50%.

Merger and mutual-fund mania still are pumping up Wall Street. Yet rising volatility in bonds and stocks signals a loss of momentum and growing risks.

Nevertheless, the end of the great financial bull market defies rational analysis. Valuation yardsticks for stocks are at unprecedented extremes. The trouble is, they can stay excessive for quite a while. Yet, in essence, this is a statement about the level of risk. In the end, every bubble bursts. A big reversal on Wall Street would be disastrous for stock markets around the globe.

Europe has its widely publicized employment problems. Even in periods of rapid recovery, job growth is sluggish. In times of slow growth, jobs are destroyed. But, combined with recent wage moderation, high unemployment has brought sharply lower inflation rates to many European countries, contrasting with rising U.S. inflation rates.

The consensus expects that a strengthening U.S. economy and rising inflation rates will be the catalyst for a further rise of the dollar. We think that by adversely affecting U.S. financial markets, higher inflation will tend to curtail capital inflows and thus will weaken the dollar.

To boost the dollar would require a truly drastic monetary tightening by the Fed, as in 1980-83. That, however, is not in the cards.

### **THE RICHBÄCHER LETTER**

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